meridian

ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

It has been an unsettled quarter for international equity markets as concerns about the consequences of losses in individual financial institutions and the effect of the credit crunch remain at a high level. Currency movements have been a notable feature with sterling falling heavily against most leading currencies with the exception of the US dollar where it was only marginally weaker. Government bonds strengthened on worries about credit markets.

The tables below detail relevant movements in markets :

International Equities 31.12.07 - 31.03.08

Total Return Performances (%)				
Country	**Local Currency**	**£**	**US$**	**€**
Australia	-14.6	-11.1	-11.3	-18.1
Finland	-18.1	-11.1	-11.2	-18.1
France	-15.5	-8.2	-8.4	-15.5
Germany	-18.2	-11.3	-11.4	-18.2
Hong Kong, China	-18.4	-18.1	-18.3	-24.6
Italy	-18.3	-11.3	-11.4	-18.3
Japan	-17.4	-7.2	-7.3	-14.5
Netherlands	-13.7	-6.4	-6.5	-13.7
Spain	-12.0	-4.5	-4.6	-12.0
Switzerland	-14.2	-1.7	-1.8	-9.4
UK	-10.3	-10.3	-10.4	-17.3
USA	-9.5	-9.3	-9.5	-16.5
Europe ex UK	-15.4	-7.4	-7.6	-14.7
Asia Pacific ex Japan	-11.9	-10.3	-10.4	-17.4
Asia Pacific	-14.7	-8.7	-8.9	-15.9
Latin America	-3.9	-1.1	-1.3	-8.9
All World All Emerging	-9.9	-10.0	-10.2	-17.1
The World	-11.4	-8.7	8.8	-15.9

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +1.4%

International Bonds – Benchmark Ten Year Government Bond Yields (%)

Currency	31.12.07	31.03.08
Sterling	4.57	4.35
US Dollar	4.04	3.43
Yen	1.51	1.28
Germany (Euro)	4.32	3.90

Sterling's performance during the quarter ending 31.03.08 (%)

Currency	Quarter Ending 31.03.08
US Dollar	-0.2
Canadian Dollar	+3.8
Yen	-11.0
-7.9	-7.9
Swiss Franc	-12.8

Other currency movements during the quarter ending 31.03.08 (%)

Other Currency	Quarter Ending 31.03.08
US Dollar/Canadian Dollar	+4.0
US Dollar/Yen	-10.9
US Dollar/Euro	-7.7
Swiss Franc/Euro	+6.0
Euro/Yen	-3.6

Significant Commodities (US dollar terms) 31.12.07 – 31.03.08(%)

Significant Commodities	30.11.07 – 29.02.08
Oil	+10.1
Gold	+11.5

Markets

Convulsions in the credit markets have temporarily taken their toll on international equity markets which have endured a weak quarter. In local currency total return terms, The FTSE World Index returned -11.4%. Currency movements reduced the decline to -8.7% and -8.8% respectively in sterling and US dollar terms but currency strength in the euro meant a return of -15.9% on the FTSE World Index in euro adjusted terms. Looking at the local currency returns relative to that of the FTSE World Index, we see outperformances from the UK, USA, Latin America and emerging markets. The performance of Latin America continues to be remarkable. In a poor quarter for international equity markets, a negative return of just 3.9% is an excellent achievement on top of a long period of outperformance. On the other hand, in local currency terms, there were underperformances from Europe ex UK, Japan, Hong Kong - China, Japan and Australia. However, the dramatic effect of currency movements over the last quarter paints a different relative picture for sterling, US dollar and euro based investors. For sterling and US dollar based investors (the currencies moved very closely last quarter with sterling fractionally the weaker of the two), the strength of the yen and euro meant that Europe ex UK and Japan outperformed the FTSE World Index in sterling terms. It is worth pointing out the remarkable sterling and US dollar adjusted performance of Switzerland where the extreme strength of the Swiss Franc meant that, in those currency terms, the negative performance was very minor. It is also worth pointing out that the remarkable relative performance of Latin America in local currency terms detailed above was enhanced against sterling and the US dollar by currency strength (although not against the euro) so that the negative return in those two currencies was minimal.

Turning to the international bond markets, top quality government bonds have benefited from the turmoil in financial markets as they are perceived to be a safe haven in uncertain times. We shall comment on the bond market later on in this review but, for now, we should note that, over the last quarter, the gross redemption yields on ten year sterling government bonds declined by 22 basis points to 4.35%, on US government bonds by 61 basis points to 3.43%, on Japanese government bonds by 23 basis points to 1.28% and on German government euro denominated bonds by 42 basis points to 3.90%.

There have been substantial movements in currencies during the last quarter for different reasons. The yen and Swiss franc have both performed very strongly. Against the yen, sterling has fallen by 11.0% and against the Swiss franc it has fallen by 12.8%. Dealing firstly with the strength of these two currencies, this can be explained by the unwinding of "carry trade" positions. As low yielding currencies, they were used to finance positions in higher yielding currencies but now, as risk aversion sets in, these positions are being unwound rapidly. We have repeatedly said in these reviews how dangerous this policy could be and the consequences of these trades are now being seen in the foreign exchange markets. Sterling and the US dollar both rose against the Canadian dollar which had been an exceptionally strong commodity driven currency. But, although the US dollar captures the headlines in the foreign exchange markets, we think the more immediate story is the precipitous decline in sterling. It was even fractionally weaker than the US dollar over the quarter. We have often discussed in these reviews our belief that sterling was overvalued but shifts in sentiment, when they come, can be very dramatic. We will discuss the reasons for sterling's fall later but it has certainly been one of the financial features of the quarter.

In commodity markets, oil and gold have continued to rise, by 10.1% and 11.5% respectively, although both are back from their high points as speculators reversed their positions.

Economics

- *Volatile market conditions prevail*...... uncertainty as to where the next problems will turn up unsettle investors.
- *Forced selling depresses asset values*...... de-leveraging creates a vicious circle.
- *Banks hoard cash*...... this causes stress in the interbank markets as interbank rates move well away from base rates.
- *The central banks take action*...... this is particularly the case with the Federal Reserve which slashes interest rates aggressively and acts imaginatively as lender of the last resort.
- *In the future, banks will become more conservative*...... they have had a nasty shock and shareholders will not thank them for taking excessive risks again.
- *Increased regulation of financial institutions will follow*...... regulators and governments will not want a repeat of recent financial turmoil.
- *Hedge funds are likely to come under more scrutiny*...... greater transparency is likely to be demanded at the very least.
- *The downturn in the financial sectors will hit some economies quite hard*...... the UK is an example where the sector accounts for around 10% of GDP.
- *Macro economic growth will be affected but is unlikely to lead to a recession*...... fast growth in the east will be a stabilising force and Europe is holding up quite well.
- *But inflation is a problem although not on the scale of previous inflations*...... energy and food prices are driving up prices. Nevertheless, "stagflation" is an unlikely outcome for the world economy.
- *Sovereign wealth funds have been a helpful influence*...... they have provided funds for some of the large financial institutions and the protectionists have found these moves difficult to criticise.
- *Government bonds have benefited from the flight to quality but yields are unrealistically low in any but the most exceptional of circumstances*...... bonds look very expensive and, as investors become less risk averse, are likely to fall in price.

- *Within the eurozone bond markets there have been some telling developments......* government bond spreads have diverged sharply according to perceived risk. For instance, there is over a 50 basis point spread between German and Italian ten year bond yields and one of about 20 between German and French bonds. Effectively, a different interest rate policy is being applied to the various economies of the eurozone.
- *Currency movements have been a feature this quarter......* sterling has plummeted against the European currencies, particularly the Swiss Franc, and against the yen. We think the perception of the UK has changed.
- *The unwinding of "carry trades" accounts for the strength of the Yen and Swiss Franc......* because of their low interest rates, they were used to fund investments in higher yielding currencies. This was a high risk strategy and increased risk aversion has led to a rapid unwinding of the positions.
- *The OECD, in its recent interim assessment, downgrading growth expectations points to three negative factors......* the spillovers from financial markets to the real economy through the availability or cost of finance with negative wealth effects affecting demand, the US housing market and the effect of rising food and energy prices. It also highlights the fact that targeted inflation rates have been exceeded.

USA

- *Fourth quarter of 2007's growth estimate confirmed at 0.6% annualised......* this compares with the previous quarter's 4.9%.
- *A significant economic stimulus has or is to be applied shortly......* there has already been an aggressive easing of monetary policy, with probably more to come, and a US$170 billion fiscal stimulus is to be applied shortly, mostly benefiting households but also benefiting businesses.
- *Thee is little sign of the housing market recovering......* most indicators still point downwards and excessive inventory levels of unsold houses have to be run down for the market to be in equilibrium.
- *An easing of the limits on the two government sponsored mortgage institutions, Fannie Mae and Freddie Mac, is planned......* this should allow the injection of another US$200 billion into the housing market.
- *Inflation figures coming out in March showed a slightly better picture......* but it is too early to be sure and food and energy price pressures are still apparent.
- *Most economic indicators, published in March, showed a negative bias......* but there was the odd bright spot and the trend in the services sector looked better.
- *There is always a time lag between a stimulus being applied and the results coming through......* so we are unlikely to see a more positive trend in the economy until later this year.

Japan

- *The sudden sharp upward movement in the yen causes concern......* the finance and economy ministers worry about the effect this could have on corporate profits.
- *The economy grew quite rapidly in the fourth quarter of 2007 at an annualised rate of 3.5%......* but it is likely to have slowed since with the OECD seeing the economy growing by 0.3% in the first quarter of 2008 against the previous quarter and 0.2% in the second quarter compared with the first.
- *However, the profile of Japanese exports gives it some protection against a slowdown in the USA......* exports to China, the Middle East and the EU continue to grow strongly.

- *Capital spending was weak in the fourth quarter of 2007......* it fell by 7.7% and with Japanese companies, according to the Bank of Japan, working on a rate of the yen / US dollar of 100-113 in the second half of 2007, they may be more cautious still now.
- *The opposition is causing problems for the government......* it blocks the government's nominee for the Governorship of the Bank of Japan and forces the government to withdraw part of the petrol tax which the government estimates will amount to around 1% of GDP.

Europe Ex UK

- *The "one size fits all" monetary policy causes problems for eurozone economies......* economies are diverging and a single interest rate is unsuitable.
- *Inflation is a problem for the ECB......* it rises to 3.5% in March, over 1.5% above the top of the target range. It has a much higher priority in the ECB's considerations than in those of the Federal Reserve.
- *However, the ECB is also concerned about the euro's rapid rise......* it will make life difficult for many eurozone exporters.
- *Money supply growth and bank lending continue to grow rapidly......* latest M3 figures show an annual increase of 11.3% whilst lending to non financial corporations grew at an annual rate of 14.8% in February.
- *Consumers remain reluctant to spend......* sentiment is poor as shown by the EC's economic sentiment survey, which shows the tenth consecutive decline in sentiment.
- *Germany continues to perform relatively well as a result of the profile of its economy......* but inflationary pressures are rising and the lid is coming off some pay increases. The ECB will be watching this development.
- *Sentiment is mixed in France......* business confidence rises slightly but consumer confidence, as measured by Insee, is at its lowest since its survey began 21 years ago.
- *France has to make progress with its reform agenda......* but the government performed poorly in recent local elections and there is only a limited window of opportunity to push ahead with reforms when the momentum is behind it.

United Kingdom

- *Sterling weakens considerably......* a combination of factors contributes to this situation but the imbalances in the economy, which have always been a threat to sterling, have now come to the fore. Exporters will, however, benefit.
- *Excessive growth in public spending has led to the predictably poor state of government finances......* there is now no room to offset the economic slowdown with fiscal reflation. Tax rises on businesses are singularly inappropriate at this stage of the economic cycle.
- *Only limited room for interest rate cuts......* inflation is above target and the public's expectations on inflation have risen. The Monetary Policy Committee will be looking at this indicator closely.
- *The all important housing market is weakening......* some indicators show falling prices and the credit crunch is making financing more difficult. A negative wealth effect will be felt and this threatens a further weakening in consumer confidence and consumer spending.

China

- *Top priority is being given to controlling inflation......* the target is to keep inflation "around 4.8%" for 2008. This will be very difficult with the latest inflation figure standing at 8.7% in February. Food prices are a major contributor to rising inflation.
- *The Bank of China raises bank reserve requirements again......* to try to restrain credit, it now raises the level to 15.5%.
- *The economy is likely to slow down a little this year......* so far this year, industrial output is rising at a slightly lower pace than last year, an annual rate, in the first two months of 2008, of 15.4% compared with 18.5% last year.
- *However, even if economic growth falls to the high single digits this year, China is likely to be a factor stabilising the world economy......* for its own domestic reasons, China needs to grow very rapidly.

Summary

- *The situation in financial markets is serious but it is being addressed......* the Federal Reserve, in particular, is taking aggressive measures to free up the interbank market and stimulate an economic recovery.
- *It is important for investors to look ahead......* yes, the situation is uncertain at present but the US economy should start to recover later this year and many companies are still doing well. Nor are share ratings unduly high.
- *Whilst bonds have performed well this quarter, we believe yields are too low......* inflation is still a concern and, in the UK, the government has to borrow heavily in the bond market to finance its excessive deficit.

It has been a troubled quarter for financial markets as the fallout from the problems in the US subprime mortgage market continues. As a result, markets have been volatile throughout the quarter. In times like this, it is important to shut out the "noise" of the market and try to assemble in one's mind factors that are more relevant to making an informed judgement about what is likely to happen. Whilst globalisation of markets is good economically, risks do accompany this development and, in this respect, we are seeing problems in a sector of the US economy turning up in all sorts of unexpected places. Subprime problems in the USA cannot be confined to that country. Essentially, the financial system operates on the basis of trust and that is in very short supply at present. This is because the system has become so opaque as a result of all sorts of new vehicles being created which did not exist before. So, for example, banks become fearful of lending to each other because they do not know what risks others, to which they may lend, have taken. In the search to put on more business, additional risks have been taken and certain hedge funds, for example, have become excessively leveraged. Forced selling of securities to meet redemptions or bank requirements has driven down the value of certain assets below what would normally have been expected, even though they may be assets of the highest quality and this has led to a vicious spiral exacerbated by excessive leverage having been used. Historical data, which has provided the rationale for certain investment policies, has not provided good guidance this time, resulting in unfortunate investment results. Certain quantitative strategies have broken down because of exceptionally unusual price movements. Very broadly, this uncertainty has caused banks to hoard cash which has caused severe stress in the inter bank markets as interest rates move to levels well in excess of what would normally have been expected relative to base rate.

This leads to one of the two roles of central banks, namely taking action to keep orderly markets in the banking sector. The Federal Reserve, the Bank of England and the ECB have all been active in this respect but none more so than the Federal Reserve which has pulled out all the stops to prevent the banking system seizing up. It has been prepared to take in a much wider range of collateral against which to lend. It has reduced the discount rate (the rate at which banks borrow from it) relative to the target federal funds rate and it has tried to reduce the stigma attached to banks using its discount window. It has also allowed investment banks to use the discount window. Eye catchingly, it acted to stave off the severe problems which Bear Stearns was facing by brokering and facilitating, through the New York Federal Reserve, its acquisition by JP Morgan Chase. The two other central banks have also been active in trying to lubricate the interbank market through their actions in the money markets. It is the Federal Reserve, however, which has attracted the most attention by its actions. Indirectly, by lowering short term interest rates relative to long term rates, banks' profitability should be helped as they play the yield curve. As with the savings and loan crisis about twenty years ago, this will help to recapitalise banks.

In its role of directing monetary policy, the Federal Reserve has acted decisively as it has done before. We have often remarked in our reviews that the Federal Reserve has the ability to take a much broader view of the US economy than can, say, the Bank of England and the ECB of their respective economies as they are tied to inflation targets. But by taking down the target federal funds rate by 300 basis points to 2.25%, it has acted decisively to try to move the US economy back on course. Monetary policy operates with a lagged effect so it will be some months before the beneficial effects start to show. But with the fiscal stimulus to the US economy, which is coming in May and which we will talk about later, this is a powerful boost to the US economy. In terms of investment policy, investors have to remember that unexpected financial events do occur quite regularly. In the last decade or so one thinks, for example, of the Asian and Russian financial crises and the collapse of Long Term Capital Management. In each case, the authorities acted swiftly to counter the situation. This is not to be complacent about what has happened recently. It is serious and there will be more casualties but the authorities have every incentive to try to take measures which will counteract the problems and help to alleviate the position.

How is all this going to play out? For a good while yet, the effects are likely to be profound. If history repeats itself, somewhere down the line excesses will reappear but that is likely to be some way off so most value will be obtained by focusing on the outlook over the next few years.

Regulation of the financial sector is likely to increase. Central banks, regulators and governments have had a nasty shock and will look to learn the lessons and implement changes. The explosive growth of off balance sheet vehicles which has caused such grief is bound to be looked at and the capital adequacy of banks considered in these circumstances. Much more transparency will be required. Banks will be encouraged to be more like banks one knew in the past in that loans they make will be on their balance sheets. Obviously, banks themselves, at least for a while, will be much more cautious about the type of business they do and take a much more robust look at the ability of the borrowers to repay their loans and service their debts. They will strive to do better quality business and, to offset lower volumes of lending, will look to raise their margins. Part of the problem has been that forced selling of securities, albeit good quality ones, has pushed down prices to unexpected levels which has made the rating of some securities more difficult. There will be closer supervision of banks to try to ensure that the present situation is not repeated. There is also likely to be more regulation of securities' markets and hedge funds. The unfounded bear raid on HBOS will have enormous ramifications. Whilst short selling is perfectly legal, market manipulation is not. Whilst the FSA is investigating what happened, it is perfectly clear that HBOS was the subject of unfounded allegations about its financial position. That the company, Bank of England and FSA had to put out statements shows the seriousness of what happened. It threatened the banking system and the savings of many people invested in HBOS. Some action on short selling is likely, probably in the way of increased transparency. The leverage employed by some hedge funds has obviously contributed to distress in markets let alone to those investors who have lost money by being in ones which have failed or diminished in value. Here, market forces are more likely to come into play as hedge funds find it more difficult to gear up to the level some of them have been doing. It will no longer be possible to obtain finance as easily or on the terms offered before.

So what effect on the international economy is the turmoil in financial markets going to have? It should be possible to make some educated guesses but there will also be unexpected developments which we cannot presently foresee. As we have said, there is bound to be tighter regulation of financial institutions as regulators try to absorb the lessons of what has happened. For the banks, there will be tougher capital adequacy requirements almost certainly. That will be needed to give greater confidence in the banking system which should help to alleviate the stress currently being witnessed in the inter-bank market. Banks will learn the lessons from the difficulties off balance sheet vehicles have caused for them. For a while, bankers, for regulatory and business reasons, will become more conservative, doing less business than they would otherwise have done but it will be better quality business and, almost certainly, at higher margins. In the short term, this will have the effect of restraining economic growth but, after that, growth should be better quality and more sustainable, this conclusion with the caveat that no unexpected external event occurs to make this scenario unrealistic. Taking out of the equation what is currently happening to the housing markets in the USA and UK, the excesses of what we have seen in the housing markets are not likely to occur for some time for three reasons. Firstly, financial institutions will be much more cautious about whom they lend to, secondly they will not advance as much (the days of 125% mortgages are surely gone) against the value of the property and, thirdly, they are likely to take higher margins on their lending as cut throat competition fades. Whilst this is going to be tough on some of those wishing to buy property or re-mortgaging, it is likely to make property prices more stable and this could help to relieve inflationary pressures in the relevant economy. For hedge funds and private equity, funding is going to be much harder and the burgeoning growth of these sectors is surely going to be halted, at least for a while with perhaps conventional investments gaining ground again. For an economy like that of the UK, with an important financial sector, the economic effects of the fallout will be more severe. Lay offs are likely to gather pace, tax revenues be affected and those areas of the economy which have benefited from the boom in the financial services sector will suffer disproportionately.

The macro economic effects will revolve around the slowdown in economic growth against the level it would otherwise have reached in the absence of the fallout from the problems in the US subprime market. The issue is clouded by the two speed growth in the world economy with the main industrialised nations lagging behind countries such as China and India which have given world growth strong impetus. A slowdown in economic growth would normally lead to lower inflationary and interest rate expectations as well as the possibility of fiscal reflation which would then lead to the probability of an upturn in the economic cycle. Slower growth can be expected to lead to a reduction in demand led inflation. For example, weaker consumer spending can be expected to lead to fierce price competition amongst retailers which will restrain prices. But cost push inflation could negate demand led factors. Energy price increases are substantial. Oil is now at over US$100 a barrel. There are various reasons put forward as to why this is happening. Strong demand from fast growing economies like China and India is an obvious factor but slower growth there as well as in the West might be expected to cause prices to fall. OPEC says that there is plenty of oil available and blames speculators. But OPEC seems to be successful in maintaining prices at ever higher levels and, even now, some of the more militant members are seeking output reductions. It seems likely that, even at a time of slowing economic growth, OPEC will exert an increasing influence on prices as its share of output rises and this source of cost push inflation will still be present. Food prices have been rising rapidly and are also a source of cost push inflation, independently of what may be happening in the world economy. Rising living standards and setting aside land, previously used for food, for biofuels are also exerting an independent cost push element. The worst outcome for the world economy would be "stagflation", little or no growth and high inflation. Whilst this cannot be ruled out, it is unlikely because of strong growth in the East, which looks likely to continue even if not at quite the current levels, and the very aggressive pro growth monetary and fiscal policy taking place in the USA. Perhaps the USA is fortunate in having, as its Chairman of the Federal Reserve, an expert on the Great Depression. This may explain the decisive and aggressive action taken on interest rates as well as other unconventional moves to free up the financial markets. As measured by the federal funds rate, real interest rates are negative in the USA and, although concerned about inflation, the Federal Reserve is pulling out all the stops to get the economy moving again so that at least the economic stagnation part of "stagflation" is tackled. It would not be surprising to see interest rates cut again, remembering that it is not so long ago that the Federal Reserve cut interest rates to 1%. Negative real interest rates pose a longer term inflationary threat but that is a risk the Federal Reserve appears happy to take in order to stabilise financial markets.

In the financial sector, although many banks, investment banks and insurance companies have taken a hit through write offs and markdowns, the really serious losses, on the information which is currently available, have been in specific institutions rather than being generally spread so it is not possible to generalise about the sector. Some banks have shown their confidence in their prospects by raising their dividends. All of the top five UK banks have recently raised their dividends. It is clearly in this sector where the most doubt lies but we might be in the position where most of the information is known about which companies have experienced serious losses or write downs as opposed to those with manageable ones. All of them will plan to be more conservative which is good for investors whose confidence will probably rise as a result. Whilst the financial sector has been the worst hit, property shares have been badly hit although they appear to have moved off their low points earlier than the banking sector. A weaker economy will affect rental values and the significant weakness of the commercial property sector reflected a move away by investors who had chased property as an attractive sector. Open ended funds, which have to meet redemptions through sales if they have insufficient cash, have become forced sellers at depressed prices. But everything has a price and the significant discounts to net asset values of, for example, some leading UK real estate investment trusts seem excessive. So, in the case of the banks, high dividend yields and, in the case of real estate investment trusts, the significant discounts to net asset value lead to the conclusion that, even if conditions remain difficult for a while, the share prices take care of this. In countries like the USA, UK and Spain (because of the sharp downturn in property prices following the construction boom), the negative wealth effect is impacting on consumer spending affecting a wide range of companies in the retail sector although the companies' experiences will differ depending upon their niche of the market. Manufacturing companies in weak currency countries or even a hard currency one like Germany which is exporting to strong growth markets like the East may continue to do well, reflecting the two speed growth of the world economy. We will look at the latest growth forecasts shortly but it is clear from what has happened in recent months that progress amongst different sectors of the market will be uneven. The short term economic effect of the turmoil in the financial markets will be slower growth than we would have expected this time last year and the short and medium term effect will be on the type of business that financial companies will do in future with the emphasis in the banking system on quality rather than quantity. If situations like the present can be avoided, which have resulted from unwise risks having been taken, then the quality of economic growth should be better and more sustainable.

As well as central banks, particularly the Federal Reserve, taking aggressive action to stabilise financial markets, individual financial institutions, which have been badly hit by losses and write downs, have, in some cases, bolstered their capital base. Sovereign wealth funds in the Middle East and Far East have provided new capital to repair these banks' finances. We have written at length in previous reviews about the potential importance of sovereign wealth funds. The need for additional capital by major western financial institutions has meant that there has been less immediate opposition to their involvement. In the wider context, we have indicated that with their vast resources and the desire to raise the return on their funds, equity is an obvious class of asset which should benefit. Our hope is that protectionist barriers will not be erected to deter sovereign wealth investment because any country which does this will be the loser. Only in very sensitive areas, such as defence, is there a case for some restrictions but, elsewhere, the recycling of surplus funds by long term investors should be beneficial for the world economy and equity investors.

In summary, what has happened in financial markets will impose a dampening effect on the world economy. It does not mean, and it will probably not happen, that the world economy will experience negative growth, but, rather, that growth will not be as strong this year, and probably next year, as expected. Some economies will be hit harder than others, probably those which are vulnerable to a housing downturn. But offsetting this contractionary influence to some extent will be monetary policy and, in the USA, fiscal policy which is looser than might have been expected previously. Equity investors should bear this in mind and not be unduly influenced by current negative sentiment.

Temporarily, high quality bonds have benefited from the events in financial markets as investors have moved to less volatile investments. But valuations are extreme and cannot, we feel, be justified on fundamental grounds given the inflation outlook. The five year US Treasury bond, for example, at the time of writing has a gross redemption yield of 2.58% offering no real return when inflation is taken into account. Whilst the yields on ultra long dated bonds have tended to creep up over the last quarter, except in the USA, those on ten year government bonds have come down. In relation to inflation, these represent a very poor return. Given a move towards normality in markets and returning confidence to equities, these yields can be expected to rise. As we shall discuss when we come to the UK, there will be a plentiful supply of new government stock coming on to the market because of the government's large borrowing demands.

An interesting development in eurozone bond markets has been the widening of spreads between what are seen as different credit risks within the eurozone. It has long been our view that the eurozone is not an optimal currency area and that the characteristics of the countries which comprise the eurozone are so different that a common currency and monetary policy is very unlikely to work. The strains are already beginning to show in a number of ways, one of which is in the eurozone bond market. At the end of 2007, the gross redemption yield spread between ten year German and Italian government bonds, to take the largest and third largest eurozone economies, was 31 basis points. At the time of writing this, the spread has widened to 52 basis points. Between the two biggest eurozone economies, Germany and France, the spread has widened from 10 basis points to 22 basis points. These are quite serious numbers. Whilst it can be argued that these differences point to the need for the higher yielding bond countries to put their houses in order to reduce the yield spreads, in practice the "one size fits all" monetary policy determined by a single ECB interest rate is coming unstuck as different longer term interest rates apply. This spread of interest rates makes it difficult to see how the eurozone economies can converge as originally planned. For short term interest rates, housing market problems in Spain and Ireland might indicate lower interest rates in those countries if their central banks had the power to determine short term interest rates but, of course, they do not. In fact, the nearest ten year government bond yield to that of Germany is currently that of France which, as we have said, is 22 basis points away. Although the strains in the eurozone bond market have not attracted as much attention as perhaps they should, because of what is going on elsewhere, they should not be ignored.

A further by product of the fall out from the US subprime problems is in the currency markets. Although some European banks have been badly affected (in Switzerland and Germany for example), the main problems have arisen in the USA and UK. Sterling has fallen dramatically in the last quarter to join the US dollar as being a weak currency and the converse of this has been significant strength in the euro (the Swiss franc's even greater strength derives from the unwinding of carry trades, the same position as the yen is in). This is causing problems for some exporting companies in Europe and leading to pressure, notably from France, on the ECB which will be resisted. The relatively hard line taken by the ECB, because of inflation being well above target, is still pushing the euro higher. Whilst there are a number of reasons for sterling's weakness, Northern Rock is certainly a factor because it has undermined confidence in the financial system.

The OECD has recently published its interim assessment of the economic outlook for its members. For the G7 countries overall, it sees growth in the first quarter of 2008 0.3% higher than in the last quarter of 2007 and 0.2% higher in the second quarter compared with the first. But, for the USA, it sees hardly any growth at all, just 0.1% in the first quarter and no growth in the second quarter. It is more optimistic about the eurozone seeing 0.5% growth in the first quarter of 2008 compared with the fourth quarter of 2007 and 0.4% growth in the second quarter. Within the eurozone, it sees quite a buoyant position in Germany with quarter on quarter growth rates in the first and second quarter of 2008 of 0.6% and 0.4% respectively. For Japan, the forecasts are 0.3% and 0.2% respectively, and, for the UK, 0.6% and 0.6% respectively although, instinctively, those rates seem on the high side with further information about the state of the economy which is coming through.

Three negative factors affecting domestic and international economies are highlighted by the OECD. The first is that problems in the financial markets have spillovers into the real economy through the availability or cost of finance. Negative wealth effects from falls in asset prices are highlighted as a factor affecting demand. Secondly, the effect of the downturn in the US housing cycle is estimated at a negative 1% of GDP over the past two years with negative effects continuing. Thirdly, the effect of rising energy and food prices on household disposable incomes are cited.

The OECD also highlights that targeted inflation levels in important economies have been well exceeded. As we have discussed, this is a problem for monetary policy makers seeking to avoid "stagflation".

So, it is against this background that we turn now to look at different parts of the world economy, starting with the USA.

Final estimates of fourth quarter 2006 growth remained unchanged at 0.6% annualised, a sharp drop from the previous quarter's 4.9%. As we saw from the OECD's latest economic update, little or no growth is expected in the first half of this year as a result of the fallout from the subprime housing market problems. However, looking to the second half of the year, there should be more positive expectations as a result of the lagged effect of the sharp cut in interest rates (the Federal Reserve cut interest rates a further 75 basis points in March to 2.25%) and fiscal stimulus of US$170 billion being enacted shortly, two thirds of which will benefit households and one third business. Although one would have preferred to see a stronger fiscal position in the USA from which to provide these reflationary measures, the improvement over recent years to a budget deficit of 1.2% of GDP in 2007 at least makes the reflationary measures, which are forecast to take the budget deficit up to 2.8% in 2008, not seem rash. The effects of this reflation are what equity investors in the US market have to look forward to later this year.

For now, we can look at some of the latest data, starting with the housing market from where the present financial problems started. The Mortgage Bankers Association said, in March, that a record 0.83% of US home loans had entered the foreclosure stage. Housebuilding starts fell by 0.6% in February and the number of new permits for residential construction fell by 7.8% in February to the lowest level since September 1991. On a more cheerful note, the National Association of Realtors reported that existing home sales rose by 2.9% in February although they were still 23.8% lower than a year before. Prices are weak, with the NAR reporting that house prices fell in March by 8.2% compared with a year earlier. Slightly more encouragingly, there was a small drop in the homes for sale inventory which was down to 9.6 months' supply compared with 10.2 months in February. The Standard & Poors / Case Shiller house price index fell by 2.4% in January, and this level was 10.7% lower than a year before. Sales of new homes fell by 1.8% in February. Although the inventory of unsold houses came down slightly as detailed above, it is still well above its normal level. The Treasury Secretary made a perfectly valid remark when he said that house prices would have to fall further for the housing market to stabilise. About six month's inventory level is generally accepted to represent an equilibrium position. This time last year, one hoped that the position would firstly have stabilised and then improved by now but this is clearly not going to happen for a while. The drag on the US economy, mentioned by the OECD, has to be offset elsewhere which is where the monetary and fiscal stimulus kicks in, together with buoyant exports. In a further attempt to assist the housing market and financial sector, US regulators plan to allow the government sponsored mortgage institutions, Fannie Mae and Freddie Mac, to inject another US$200 billion into the housing market.

Whilst the Federal Reserve has downgraded inflation temporarily as a driver of monetary policy in favour of decisive action to kick-start the economy, it would be enforcing its actions much more strongly in normal circumstances. Whilst the consumer price index was unchanged in February, the year on year rate was 4.0%, although this was an improvement on the previous month's figure of 4.3%. The core consumer price index, which excludes food and energy, was also unchanged in February with the year on year rate at 2.3% compared with 2.5% the previous month. The preferred measure of the Federal Reserve, the core personal consumption expenditure deflator, rose just 0.1% in February to give a rise of 2.0% year on year, at the top of the Federal Reserve's target range. The producer price index was 0.3% up in February compared with 1.0% in January to give a year on year increase of 6.4% compared with 7.4% in January. Although these are just one month's figures and therefore not statistically significant, the fact that they show a better trend makes it easier for the Federal Reserve to concentrate on getting on with the business of kick-starting the US economy. However, in deciding not to cut interest rates by a full 1% at its last meeting, the Federal Reserve referred to its concerns about inflation and said that "uncertainty about the inflation outlook had increased".

Most of the news recently has had a negative bias in the USA, as one might expect. Giving random examples of this, we saw a fairly negative ISM survey of manufacturing activity for February which fell to 48.3 from 50.7 in January. The Commerce Department reported that new factory orders fell by 2.5% in January. The US Federal Reserve reported a decline in the net worth of US households in the last quarter of 2007. This dipped to US$57.72 trillion from US$58.25 trillion in the third quarter. The importance of this is that it can create a negative wealth effect for consumers which can fan through to the economy. In the jobs market, non-farm payrolls fell by 63,000 in January which was the most for almost five years and marked the second monthly decline running. There was a downgrade of previous estimates for December and January. February's retail sales were weak. They fell by 0.6% compared with an upwardly revised 0.4% gain in January. If cars are excluded, sales fell by 0.2%. Consumer confidence, not surprisingly, has been weak. The University of Michigan's consumer confidence index, according to the first snapshot for March, remained close to February's levels of 70.8, the preliminary reading being 70.5 for March. According to the Conference Board's index of consumer sentiment, the level fell to 64.5 in March from 76.4 in February and this represents the lowest level for almost five years. Durable goods orders fell by 1.7% in February following a 4.7% decline in January. In the final quarter of 2007, US corporate profits fell by 3.3%, a larger fall than expected. Consumer spending in February was almost unchanged on January, rising by just 0.1%. On the positive side, there was an improvement in the services sector as measured by the ISM's non manufacturing composite index. Although below 50, it rose from the low point in January of 44.6 to 49.3 in February. Its non manufacturing business activity index rose 8.9 to 50.8 with new orders improving by 6.1 points.

So, at present, markets are waiting for the stimulatory effect of lower interest rates to be felt and the forthcoming fiscal reflation package. In the meantime, the news is expected to be generally negative but, for investors, it is important to look forward to the next stage of the economic cycle which should be for some recovery after two very flat quarters at the beginning of this year. With US shares not highly rated and the prospect of an economic recovery starting later this year, they should reflect an important part of an international equity portfolio. The competitive level of the dollar remains helpful for many US companies and many of them represent a low risk way to play emerging markets because of their exposure to them.

Turning now to Japan, as we saw from the table of equity performances at the beginning of this review, a poor return in domestic terms was mitigated significantly by the strength of the yen for foreign based investors. As is well known, the yen has been the main currency financing the carry trade and with risk aversion increasing as a result of events in financial markets, carry trades have been rapidly unwound thus creating significant demand for yen and pushing it higher. Whilst Japan has been very competitive at the low level of the yen which obtained until recently, the pace of the adjustment has caused worries in government and business circles. Both the finance and economy ministers have expressed concern that this sharp recovery in the yen could have on corporate profits. According to government estimates, a 10% rise in the value of the yen against the dollar cuts export gains by 0.8% but also reduces the total bill for imports by 1.1% of GDP. The latest growth figures from Japan, which may be somewhat academic, show the economy growing at a revised 3.5% annual rate in the final quarter of last year, an acceleration from the third quarter when the rate was 0.9%. But, as we have often mentioned before, one of the positive aspects of the Japanese economy is its close relationship with Asia, particularly China and this is helping to offset the slowdown in the USA. In February, for example, Japanese exports rose by 8.7% compared with a year earlier. Exports to China rose by 14.9% and those to the EU by 7.2% and those to the Middle East by 14.6%. These gains more than offset a 6.0% fall in exports to the USA. Helping to buoy exports was strong demand for vehicles, general machinery and steel in Asia, more than offsetting a decline in vehicle sales to the USA. Although the rise in the yen had not gathered pace at that time, there was a significant fall in Japanese companies' capital spending in the fourth quarter of 2007. It fell by 7.7% and it may well be that the subsequent rapid rise in the yen, with its effect on corporate profits, will make Japanese companies more cautious about investing since they had assumed that the yen would not have risen as much as it has done against the US dollar. The Bank of Japan reported the Japanese companies were working on the basis of a yen rate to the dollar in the second half of 2007 of 100 to 113, but that has recently broken below 100, although it is now back above it.

One of the benefits of the rising yen will be to subdue inflation although the problem has been rather the opposite in the past. In February, consumer prices were 1.0% higher than a year earlier but, if volatile food and energy costs are removed, there was a fall of 0.1%. These are figures which are not likely to cause the Bank of Japan to move interest rates from their current level of 0.5% but there is a hiatus within the Bank of Japan at present as the opposition has blocked the government's nominee and, currently, the Bank of Japan is without a governor. Given what is happening in financial markets, this is obviously not an ideal situation. Furthermore, in terms of policy making, the strengthened opposition has forced the government to withdraw part of the petrol tax which, the government estimates, will amount to about 1% of GDP. With a large budget deficit, this is an unhelpful development although it is likely to be welcomed by consumers.

Negative items of current news have been a slight rise in unemployment from 3.8% to 3.9%, according to the latest figures, and a reduction in the jobs to applicant ratio to 97 per 100 in February from 98 per 100 in January. Increased use of part-time employees is also noted. This suggests rather a cautious approach by employers. Also on the negative side, industrial production fell in February by 1.2%.

Probably the most unhelpful factor for Japanese industry is the volatile exchange rate. While small adjustments, which continue into a trend, can be more easily handled, a very sharp and sudden adjustment is difficult. It is unlikely that the yen will weaken significantly since Japan has a large current account surplus and, if risk averse investors shy away from the carry trade, they are unlikely to be using the yen to finance such transactions for some time or, if they do, it will be in a modest way. So it looks as if Japanese companies will have to get used to the strong yen but they do have the advantage of strong Asian markets for their exports which will be an important support. Efforts to cut or restrain costs are likely to be accelerated by Japanese companies in the environment which faces them. As a way of playing the relatively fast growth of Asia and, of course, China in particular, Japan has attractions despite the difficulties mentioned above.

In the eurozone, policymaking is very difficult for the ECB because eurozone economies are not performing in line with each other. This was always a huge risk for the concept of monetary union and the "one size fits all" monetary policy. In broad terms, the eurozone is performing relatively well and the OECD forecasts, which we quoted earlier on in this review, demonstrate that fact. However, within the eurozone, some countries like Germany are performing relatively well whilst Spain is facing very difficult times as a result of the severe weakness in the housing and construction market and Ireland is slowing down, too. But the ECB has to set its monetary policy by looking at the overall position and this makes life difficult for countries which are out of line with the broad average performance of countries within the eurozone in terms of inflation and growth. The real headache for the ECB is that interest rates at 4% are below a neutral level if one looks at inflation. The latest inflation figures show that the level rose to 3.5% in March from 3.3% in February which is over 1.5% above the top end of the ECB's target. This is a serious overshoot and, if measured by the ECB's interest rate, the real rate is 0.5% which would normally be considered too low. The President of the ECB said, at the end of March, that, whilst he would not "say the worst is behind us" in the world credit crisis, concern about inflation would see the ECB continue to hold interest rates. Yet he has also sounded the alarm about the rapid appreciation of the currency because of the damage it could do to the eurozone economy. Policymakers in the eurozone are really in a bind. By way of background, GDP grew by 0.4% in the final quarter of 2007 against 0.7% in the previous quarter with the rate of increase of GDP for the year being 2.2%. One disappointing feature of growth in the last quarter continues to be the reluctance of consumers to spend. In the final quarter of 2007, it is estimated that consumers in the eurozone reduced their spending by 0.1% with the Germans particularly reluctant to spend. The latest ECB estimates for inflation in the eurozone in 2008 is to be 2.9% (its earlier forecast was 2.5%) and in 2009 2.1% (1.8%). Its forecast for economic growth in 2008 is 1.7% and 1.8% in 2009, with the forecast being based on the market's expectations of significant interest rates cuts this year. The President of the ECB did not give any credence to this assumption because of the concern about inflation. Mr Trichet's assessment of the situation for the eurozone was that the fundamentals remained "sound" with investment supporting economic growth. He thought that "consumption growth should continue to contribute to economic expansion in line with rising employment". One factor which will keep the ECB fairly confident about economic activity and also concern them, because of its implications for inflation, is the continued fast growth in money supply. The latest figures for M3 show that, in February, the annual rate of increase was 11.3%, only slightly down from January's level of 11.5%. Lending to non financial corporations grew at an annual rate of 14.8% in February which was the highest rate of increase since the launch of the euro.

Individual items of news have been mixed. On the negative side, the ECB's eurozone "economic sentiment" measure shows a decline in February with a reading at 100.1 against 101.7 in January. It is a mixed picture within this total with negative sentiment in Italy and Spain whilst there was more confidence in Germany. At the end of the month, the EC's survey of economic sentiment amongst households and businesses was published and this showed a weak picture with figures showing the tenth consecutive decline in sentiment. Its headline index of confidence fell to 99.6 which is the lowest level since November 2005. Weakness in the confidence of the services sector business accounted for the main part of the decline. The eurozone purchasing managers index for the services sector fell to 51.7 in March from 52.3 in February whilst, in manufacturing, there was a small fall to 52.0 in March from 52.3 in February. On the positive side, Eurostat reported a bigger than expected increase in industrial production in January by 0.9% to give an annual growth rate of 3.8%.

Within the eurozone, Germany, as the largest eurozone economy, is obviously crucial to its performance and the news from Germany has generally been good on the economic front but not on the political front. Dealing with the economic side first, most of the news coming out of Germany recently has been positive. For example, German industrial output rose by 1.8% in January following a rise of 1.5% in December. The German statistics office reported that exports rose by 3.8% in January, the biggest monthly increase since September 2006. The profile of the German economy is helpful here with demand for its high quality machinery strong and its important footprint in emerging markets which are growing more rapidly than industrialised ones. The ZEW Research investor sentiment indicator rose to -32 in March from -39.5 in February. The Ifo Institute's German business climate index showed the third consecutive monthly increase, rising to 104.8 in March from 104.1 in February. However, the reasonably good economic situation in Germany is helping to lay the ground for further inflationary pressures. In February, producer prices rose by 0.7% after a rise of 0.8% in January which gives an annual increase of 3.8%. There is, however, strong political pressure for a significant increase in wages. Part of the recent success of the German economy has been that it has kept costs down and increased its competitiveness which has resulted in pleasing economic growth. However, trade unions in the public sector, in particular, have been pushing for large pay increases supported by industrial action and some politicians have encouraged this partly to enable employees to catch up from the time when pay increases were very subdued and partly as a way of stimulating consumer spending. The problems of the SPD which have been driving it leftwards have increased the rhetoric from populist politicians. All of this is likely to be very unwelcome to the ECB which particularly watches the development of wage rounds and, if Germany does look like conceding large wage deals, it is bound to influence the monetary policy of the ECB. Paradoxically, therefore, the relatively good position of Germany is creating an unwanted headache for the ECB at a time when other countries, like Spain and Ireland, are struggling and might appreciate lower interest rates.

The situation is not so good in France. Although Insee reported an increase in its business confidence index in March to 109 from 107 in February, consumer confidence continues to decline with Insee's consumer confidence index in March falling by 1 point to -36, the lowest since the survey began twenty one years ago. We still await the outcome of President Sarkozy's reform programme. Things have gone quiet recently and the poor performance of his party in recent local elections may weaken the momentum which had built up following his presidential and parliamentary election victories last year.

Shares in Europe remain relatively lowly rated and look attractive against bonds. With the economic situation better than in most developed countries or regions, we continue to believe this area should represent an important element of an international equity portfolio.

We now turn to look at the UK where, as we have mentioned, one of the most important issues has been the serious weakness of sterling over the last quarter. Although much attention has been paid to the US dollar, in fact, sterling has been very slightly weaker over the last quarter and this has not attracted the attention that perhaps it should have done against the background of Northern Rock and other problems in financial markets. But we think it is important. To us, it reflects a re-evaluation of the UK by foreign investors. For some time, we have been concerned that sterling has been overvalued although it remained very stable for a long time. It is very difficult to tell when currency trends will change and currencies often overshoot or undershoot a realistic value. There are enough doubts about the outlook for the UK for us to feel that recent falls have been justified and to expect that they will continue so that sterling may eventually overshoot on the downside. What has caused this re-evaluation of sterling? As we have often mentioned before, the UK economy is unbalanced. There are large internal and external deficits which render the currency vulnerable to changes in sentiment, something that has happened this quarter. The budget was a fairly depressing affair giving little cause for hope. The Chancellor reduced his growth forecast for this year to 1.75% to 2.5% compared with the previous forecasts of a range of between 2.0% and 2.5%. For 2009, the economy is forecast to grow between 2.25% and 2.75%, and for 2010 at between 2.5% and 3.0%. Further increases in government borrowing are expected. For the year which has just ended, the forecast is for it to be £36 billion and for 2008 / 9 to rise to £43 billion. Over the next four years, borrowing is forecast to total £140 billion. By 2012 / 13, borrowing is forecast to have declined to £23 billion. The Treasury has consistently underestimated the level of government borrowing and, given that growth forecasts look optimistic to many people, this situation could well be repeated. The Treasury projects that debt as a percentage of GDP will be 39.8% in 2010. In trying to raise money to cover shortfalls, taxes on cars and alcohol have been raised whilst business will experience a rise in capital gains tax and, after a great deal of controversy, changes to the rules for non-domiciled people's taxation will be brought in. Whether it raises any extra money remains to be seen given the fact that individuals may leave the UK. The large issuance of government debt could be a factor pushing up long term interest rates as the appetite for large amounts of gilts lessens. In previous reviews, we have repeatedly made the point that the growth in public expenditure was unsustainable and that it was bound to lead to problems. This is now occurring because the government has no room to be taking the sort of action that the USA is with its reflationary package. The emphasis has been on trying to raise money from all sorts of sources and, at this stage of the cycle, that is not the accepted practice. Raising taxes on business, particularly small businesses, looks completely the wrong thing to do but the very poor state of public finances has led to the government initiating short term fixes although, in the long term, the result could be damaging to the UK. At the same time, confidence in the financial system has been weakened by the Northern Rock affair and comparisons have been drawn between the way the Federal Reserve acted in the USA to deal with the Bear Stearns situation and the long drawn out affair on Northern Rock which has ended with it being nationalised. There is little doubt that confidence in the UK economy has been considerably weakened and the fall in sterling reflects this. Rightly or wrongly, it is perceived that anti business sentiment is increasing in the UK whilst the moves on the taxation of non-domiciled individuals is met with scarcely disguised disbelief abroad as other countries welcome the business which may be lost. It looks very like an own goal.

Because of the poor state of government finances, there is no real room for any fiscal action to stimulate the economy in the face of a slowdown, but is there any monetary action which can be taken in the form of significantly lower interest rates, such as those introduced by the Federal Reserve in the USA? The answer is probably "no". The Bank of England has a more closely defined mandate which relates to inflation and, whilst the Federal Reserve can relegate inflation in its list of worries, it is more difficult for the Bank of England to do so. Whilst the fall in sterling will give a welcome boost to manufacturing companies, a minor part of the economy now, and should help their exports and to compete with imports, in certain circumstances, it will be inflationary as the UK economy is a relatively open one. The Governor of the Bank of England discussed the situation recently with the Commons Treasury Committee and gave some indication that rates would be cut because of what he described as a new and difficult phase of the credit crunch which put banks in a "position of great fragility". However, he also indicated that the relatively full employment situation, relatively upbeat business sentiment and unexpectedly strong retail sales which would be factors that one would expect to limit the Monetary Policy Committee's enthusiasm for rate cuts. Somewhat surprisingly, but also realistically, he indicated to the Committee that he expected sterling to fall further as a part of the rebalancing of the economy. When public figures say these things, it can be a self-fulfilling prophecy, although the fundamentals for the UK are not encouraging at present and the re-evaluation of sterling by foreign investors in the first quarter is a strong indication of this. As well as published inflation figures, the Bank of England also looks at the public's expectations of inflation because those often inform economic decisions including pay bargaining. The latest poll suggests that this time next year, households expect inflation to be 3.3%. Last time the poll was taken the expectation was 3.0%. This was the highest reading since the exercise started in 1999. In a way, it is surprising that the figure is so low given than many households' inflation experience will be higher than that because of the incidence of rising food and energy prices. The latest consumer price inflation index rose from 2.2% in January to 2.5% in February which is well above the 2% target level and the representative retail price index, which used to be used, shows inflation unchanged at 4.1%. Producer prices in January rose by 0.8% to give a year on year rise up from 4.3% to 4.9%. Raw material prices were up 19.5% in January compared with a year earlier. Fuel costs were up 23.4% and food prices 8.4%. The latest CIPS / NTC purchasing managers index showed a sharp increase in its output price index to the highest level since it started in 1999, at 59.9.

The housing market, with all its accompanying economic effects, will provide important guidance as to how the UK economy performs because of its importance to the UK economy. One issue which has come to the fore in the credit crunch and has been much in the news in recent days is the contraction in new mortgage offers. Banks and building societies do not have the money to lend and, with wholesale borrowing costs rising because of the stress in the inter bank market, those mortgages, which are given, are both more expensive and made on a more conservative basis than in the recent boom. This could have a depressing effect on house prices for two reasons. Firstly, relatively higher mortgage rates will eat into disposable incomes and therefore affordability whilst sellers of property who are desperate may have to cut prices further to lure either those buyers who can obtain a mortgage or cash buyers. The evidence provided by the various providers of house price indices is of a cooling market and most people see ample evidence of this. The Halifax reported that house prices fell by 0.3% in February to give annual house price inflation of 4.2%, the lowest since October 2005. The FT house price index painted a slightly different story. It rose by 0.5% in February to give a year on year figure of 6.1% although this was down from the 6.8% figure of January. However, the three months to January represented the lowest monthly growth rate seen in over three years. The Department of Communities and Local Government reported that house prices rose by 1.7% in February to give an 8% increase year on year. The Nationwide index of house prices fell by 0.6% in March which reflected, by its index, the fifth consecutive monthly decline. The annual rate of house price inflation was just 1.1%, the lowest for twelve years on its records. Hometrack, the property information group, reported that house prices fell by an average of 0.2% in March. Interestingly, and not surprisingly, it reported that the number of new properties listed for sale was up by 8.4% whilst new registered buyers were up 1.9%, giving an indication of the balance of the market. Separately, the RICS noted that the UK was the only country out of twenty surveyed in Europe where the credit crunch was starting to have an impact, resulting in a noticeable drop in borrowing levels. The Council of Mortgage Lenders reported that the number of mortgages taken out in January fell by 19% to be 34% lower than a year earlier. The difficulty of obtaining mortgages is likely to exacerbate this trend. Later figures from the Council of Mortgage Lenders for February showed that lending declined by 7% compared with January and 6% less than in February 2007. The British Bankers Association reported that there was a slightly larger growth in mortgage lending in February compared with January but it was still 30% lower than a year earlier, with the number of approved home loans very slightly up in February but near a historical low. Just as we were finalising this review, the Halifax said its data showed that house prices fell by 2.5% in March.

Surveys conducted about people's attitude to the economic outlook now tend to show a fairly depressing picture. Most of the evidence points to more difficult times and this is informing people's attitudes to spending, for example. Although some sectors of the economy are doing well, manufacturing, for example, should benefit from the lower value of the pound, the news tends to be skewed toward the negative and this will not be helpful.

We have long been cautious about the UK economy but, on the surface, it has still continued to grow quite well although we have argued that the quality of the growth is not that high. Now, however, the tide seems to have turned and, whilst many share values look appealing, significant overseas exposure, which is important for portfolio diversification in any case, seems to be more important than ever because there are countries and regions with better growth prospects.

One of those areas, of course, remains China where the problems, if anything, have been of excessive growth with the authorities trying to cool down the economy in order put a lid on inflation which is well above the levels targeted. Early in March, the Prime Minister laid out China's policies and views on the economic outlook. Controlling inflation was one of the issues. The target was to keep inflation "around 4.8%" for 2008 although most commentators see this as a hard task with inflation getting on for double that rate at present. The Prime Minister continued to emphasise reform and following a "prudent" fiscal policy. In the face of the latest inflation figures from China, 8.7% in February, compared with 7.1% in January, and producer price inflation in February rising to 6.6% from 6.1% in January, the authorities raised the reserve requirements for commercial banks by 0.5% to 15.5% in order to try to curb inflation by making the availability of credit more difficult. There is some evidence of a modest slowing down in the Chinese economy. For example, in the first two months of 2008, industrial output rose at an annual rate of 15.4% compared with 18.5% in the same period in 2007. Some moderation in the growth of the trade surplus, still vast, is also evident as the number of export markets, particularly the USA, become more difficult. But China will continue to exert a positive influence on the world economy, notwithstanding its problems with inflation, and should help to limit the damage to international economic growth caused by the problems in some of the developed countries, notably the USA. China remains a very important investment consideration not only in macro economic terms but also for the countries which benefit from its rapid growth in one way or another.

After a series of mainly positive quarters, it is inevitable that there will be setbacks and the financial background has made the first quarter of this year a difficult one. Many factors have come into play but we have been impressed by the efforts of the authorities, particularly in the USA, to address the situation. It is easy to be overwhelmed by negative headlines but it is also important to try to reason through the situation in order to avoid what could turn out to be expensive investment decisions. We believe that investors should place their emphasis on the probable start of economic recovery in the USA later this year, still fast economic growth in the East and reasonable share price multiples which shall enable shares to recover from a difficult first quarter.